****R E V I S E D****

BILL # HB 2270

TITLE: corporate income tax; sales factor

SPONSOR: Huffman

STATUS: As Introduced

REQUESTED BY: House

PREPARED BY: Brian Cary

FISCAL ANALYSIS

Description

The bill would allow companies to use a corporate income tax apportionment formula that places additional weight on sales, and less weight on property and payroll, or continue to use the current formula. This formula is used in calculating how much of the income of a multi-state company should be apportioned to Arizona. The current apportionment formula places 25% weight on a company's property factor, 25% weight on a company's payroll factor, and 50% weight on a company's sales factor. The bill would permit companies to calculate their liability based on an alternative formula that places a higher weight on sales. The sales weight in this alternative formula would increase to 60% in tax year 2005 and to 70% in tax year 2006. Companies could also continue to use the current apportionment formula. The initial apportionment changes included in the bill would become effective from and after December 31, 2004.

Estimated Impact

This bill would reduce corporate income tax revenue to the General Fund based on the revised apportionment formula. JLBC Staff, however, does not have access to the corporate taxpayer data needed to derive an independent estimate of the impact. The Department of Revenue (DOR) maintains taxpayer records, and has devised an estimate of the bill's impact. Based on DOR's analysis of taxpayer data from tax years 1995 through 2001, corporate income tax revenue could be reduced by $(10) million to $(12.5) million in FY 2005 and by $(30) million to $(37.5) million in FY 2006. In subsequent fiscal years, DOR estimates the annual impact to be in the range of $(40) million to $(50) million.

While HB 2270 would lead to a direct reduction in corporate tax liabilities, the bill would create a more favorable tax environment. As a result, the bill could generate additional economic activity that would lead to an offsetting increase in tax collections. This type of secondary, or dynamic impact, is difficult to estimate. The State of California has the most advanced state government level dynamic forecasting model. Based on their model, 18% of corporate tax reductions are offset by additional state revenue within 5 years.

The JLBC Staff has also acquired an econometric model for evaluating these economic impacts. Using this model, we will attempt to develop our own dynamic estimate. The modeling can be complex, so we are forwarding the fiscal note now in the interest of timeliness.

Analysis

<u>Apportionment Formulas</u>
Current law places twice as much weight on a company's sales factor as it does on its property and payroll factors. The term "factor" means the portion of a company's activity in Arizona divided by the company's activity everywhere. The current apportionment formula is displayed below:

$$\textbf{Current:}\quad \textbf{\% of Income Allocated to Arizona} = \frac{\textbf{(25 * Property Factor) + (25 * Payroll Factor) + (50 * Sales Factor)}}{\textbf{100}}$$

The bill would increase the weight on sales in FY 2005 and FY 2006. The higher sales weighted formulas would benefit companies that own property in Arizona and employ local labor, but export their product. During FY 2005, the above formula would be modified to use a 60% weight on sales. The sales weight would increase to 70% during FY 2006 and would remain at that level in subsequent years. The property and payroll factors would be reduced proportionately.

Analysis (Cont'd)

DOR believes that the effects of the revised formula depend on the assumed level of corporate tax collections, which has been volatile in recent years. Their analysis assumes $500 million in annual corporate income tax collections, which is comparable to what was collected in FY 2000 and what is estimated for FY 2004 and 2005 by both DOR and JLBC Staff.

DOR estimates that allowing the option of choosing between the current apportionment formula and one that places a 60% or 70% weight on sales would reduce total corporate income tax liability by 4% to 5% for a 60% sales factor and 8% to 10% for a 70% sales factor. The DOR analysis assumes that for each change in the sales factor, 100% of the potential revenue loss will occur in the first tax year following the change. From a budget perspective, the fiscal impact would not occur until FY 2005 and FY 2006, respectively. Although tax liability is accrued on a calendar year basis, final tax payments and refunds are not issued until the following calendar year. The revenue loss in FY 2005 would be about one-half of the 2005 tax year estimate, or about $(3.75) million to $(5) million. When DOR analyzed a similar bill in 2003 that proposed a 100% sales factor, they assumed the revenue impact would be 25% of reduced tax liability in the first year, 90% in the second year, and 100% in following years.

Local Government Impact

Each year cities and towns receive an amount equal to 15% of income tax collections from two years prior. The reductions in corporate income tax collections would result in a reduction in local government distributions of $(1.5) to $(1.9) million in FY 2007, $(4.5) million to $(5.6) million in FY 2008, and $(6.0) million to $(7.5) million in later years.

2/2/04